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SUBJECT: BRAZILIAN ETHANOL SECTOR AND THE FINANCIAL CRISIS

REF: A. 08 SAO PAULO 0443; B. 08 SAO PAULO 0423; C. 08 SAO PAULO 0590

SENSITIVE BUT UNCLASSIFIED--PLEASE PROTECT ACCORDINGLY

¶1. (SBU) Summary: The effects of the global financial crisis are visible within Brazil's sugar and ethanol sector with industry experts estimating that about 20 percent of Brazil's ethanol mills are suffering financial difficulty. Even though the fundamentals for the sector remain positive, and sugar prices and internal demand for ethanol should fortify the sector this year, the outlook for 2009 is mixed. Some ethanol producers have good cashflow, others are saddled with debt, and many lack viable financing. Although some consolidation is inevitable, experts do not foresee a major increase in market dominance by individual companies. The biggest impact from the crisis going forward will be postponement of new projects; however, this is temporary as demand for ethanol continues to grow. Internationally, countries that had planned to develop ethanol industries could review or suspend them given the scarcity of financing as well as the lower price of gasoline. Over the long-term, Brazilian producers still anticipate that international markets (including the U.S.), in addition to high internal demand, will increase demand for Brazilian ethanol. End Summary.

In Crisis Before the Financial Crisis

¶2. (SBU) While the global financial crisis hit Brazil in September 2008, Brazil's sugar and ethanol sector had already been suffering since 2007 from falling commodity prices. Many sugar and ethanol mills took on huge obligations from 2005 to 2007 when the euphoria over biofuels brought a wave of private investment. At that time, mills had high profit margins, easy access to credit, and immense future domestic demand growth. Bank credit was easy to access, though mostly short-term rolling credit lines as bridge loans until funding from the Brazilian Development Bank (BNDES) could be disbursed, leading many mills to take on large debt burdens and assume repayment based on future revenue streams on the assumption of continued access to cheap credit. In 2008, however, excess sugar

supply worldwide led to a decline in prices that abruptly cut revenues to pay rolling credit lines. Production costs, especially for inputs such as diesel and fertilizers, rose as well. Mills began to renegotiate with banks, at higher rates, to postpone debt payments. This scenario reverberated throughout the sector affecting established ethanol producers as well as new operations. Jose Luiz Oliveiro, Vice-President for Technology and Development at Dedini, the world's largest capital goods producer for sugar and ethanol mills, told Econoff that by March 2008 the company was already experiencing a deceleration of new business.

¶3. (SBU) Already overburdened, the global crisis deepened the financial problems for many in the sector. Rolling over debt payments became difficult (at much higher borrowing costs) or impossible given credit risk. Because mills often financed improvements and expansion with their own cash savings, and then sought financing from banks and BNDES, many were left without savings to draw upon. Bradesco Corretora sugar and ethanol analyst Auro Rozenbaum estimated that approximately 20 percent of the sector has been affected by the crisis. According to Antonio de Padua Rodrigues from the Brazilian Sugarcane Association (UNICA), mills that lacked financing began flooding the ethanol market to generate cashflow, thus exacerbating the problem for all by forcing down the price of ethanol in the market. Five of the 402 sugar and ethanol mills in Brazil have already filed for bankruptcy, and many in the industry are closely following ongoing bank negotiations and possible buy-outs to signal future developments. (Note: It is hard to estimate the extent of financial difficulty across the sector. While most contacts suggested a figure around 20 percent of mills have been seriously affected by the crisis, a few bank estimates were much higher, up to 70 percent. End Note.)

Financing Options Limited and More Expensive

¶4. (SBU) The biggest current problem for the sector is access to financing. One consequence of the crisis, according to Jose Carlos Giachini from Rabobank, is that foreign denominated debt payments grew with the depreciation of the Brazilian currency relative to the US Dollar. (Note: The second largest mill is expected to have net losses of USD 26 million from October to December 2008 explicitly due to the negative foreign exchange impact. End Note.) He noted that spreads are up significantly across the sector, driving up interest rates despite the recent rate cut. Average interest rates in Brazil for companies as of December 2008 were 30 percent per year and likely higher for the ethanol sector given higher delinquency rates. Furthermore, Banco Modal analyst Roberto Nogueira told Econoff that "everyone in the sector" had taken on the toxic foreign exchange derivatives to help hedge against dramatic currency fluctuations, which also put them in a weaker financial position. (Note: In a separate meeting, the Head of Business Development for Cosan told Econoff that Cosan was one of the few mills that had no exposure to derivatives. End Note.)

¶5. (SBU) With few financing alternatives, a quick recovery for the sector is unlikely. Padua outlined three major areas where financing was needed: 1) BNDES, which provided approximately USD 350 million to the sector in 2008, excludes sugar and ethanol from its pre-shipment loans which are badly needed to help finance exports, 2) creating financing instruments to cover production costs would help stabilize prices between seasons and limit the incentive for mills without access to credit to flood the market to generate cashflow, and 3) a price-stabilizing warrantage system that pays producers to store excess production. (Note: Warrantage is a credit system in which farmers/growers stock their production at harvest when prices are low and receive cash on credit. End Note.) Despite clearly defined financing solutions, Padua told Econoff that he did not expect any widespread GOB action in the near term because it served the government politically to keep prices as low as possible. He believes a solution would be on a company by company basis, with small adjustments within the market.

Widespread Consolidation Unlikely

¶6. (SBU) As with many sectors in Brazil, interlocutors expect some consolidation, but do not expect a major systemic change in the concentration of market share within the sector. The largest producer, Cosan, has 18 mills and crushes 10 percent of the country's sugarcane. Cosan's Head of Business Development Marcelo Martins told Econoff that some companies be forced to sell mills because they cannot survive. Despite Cosan's privileged financial position, the company is maintaining a more conservative approach when considering the potential acquisition of any one of these failed mills in order to maintain a healthy balance sheet. CEO of ETH Bioenergy, Odebrecht's ethanol subsidiary, said despite the waiting list of companies wanting to sell, the company would carefully evaluate any potential acquisitions.

¶7. (SBU) Rozenbaum explained that the sector was unique and that the limited opportunities for vertical integration meant that it was not a driving force for consolidation. In fact, Cosan is one of the few mills in Brazil that operates throughout the entire value chain, from its recent land acquisition to its purchase of the Esso gasoline distribution network from Exxon Mobile last year. Rozenbaum noted that the majority of small family operated mills own land, grow sugarcane, and produce sugar and ethanol, but would not venture beyond these activities. Padua told Econoff that he expected consolidation among the bigger producers that were overleveraged rather than the smaller family producers that he believes will weather the storm. Martins agreed, noting that Cosan was targeting large mills for potential acquisition rather than

small family producers. (Note: Brazil crushed 500 million tons of cane last year. "Large mills" are generally defined as more than two million tons of cane; however, hundreds of mills crush only one to two million tons of cane per year. End Note.)

Postponement of New Investment Likely

¶8. (SBU) The most obvious near-term impact from the international crisis on the sector is likely to be a decline in the rate of production growth. Padua said that some 15 of the 35 mills projected to open in 2009, each requiring an investment of USD 200 million, would be delayed. According to press reports, investment in sugar and ethanol mills is expected to decline by 40 percent this year. Now that well-capitalized start-ups will have the option of purchasing overburdened mills at discounted prices, some expect delays in new greenfield projects. Fernando Moreira Ribeiro from ETH told Econoff that the company is reviewing its investment strategy and that many of its planned greenfield projects for 2010 and 2011 could be replaced by purchases of existing mills. He expected delays on construction of mills that were scheduled for 2010 and beyond.

¶9. (SBU) The crisis, however, did not figure into the production delays in 2008. Many mill openings delayed in 2008 were due to low sugar prices, backlogs for equipment, and slow disbursement of BNDES financing. Dedini's Oliveiro noted that projects where significant investment had already been made, including equipment purchased (36 months lead-time), growing sugarcane (60 months lead time), and building a mill, would be completed regardless of the crisis. Padua estimated that projects with 80 percent investment completed would be concluded because of the need to generate cashflow.

Prospects for 2009 and Beyond

¶10. (SBU) Industry contacts all agreed that the outlook for the sector was positive, based on strong fundamentals over the next few years. Many opined that the major difference now versus the last crisis in 1996 is the positive outlook for demand. Despite the global slowdown, demand for sugar should remain constant because it is the cheapest sweetener and not generally affected by economic downturns. Sugar prices in 2009 should recover because of a decline in production in India due to weak sugar prices, which Rabobank calculated would result in some three to four million tons in additional Brazilian exports. As a result, flexible mills (those

that can alter their ratio of sugar to ethanol) will probably produce more sugar than in 2008. Cosan CFO Paulo Diniz said the company was preparing to produce 60 percent sugar and 40 percent ethanol in 2009. (Note: The Brazilian mix in 2008 was 60 percent ethanol and 40 percent sugar because of low sugar prices and strong internal demand for ethanol. End Note.)

¶11. (SBU) At the same time, most in the sector assume that internal demand for ethanol will continue to increase. Industry consultant Julio Martins Borges of JOB Consulting expects a deceleration in internal ethanol demand, but continued growth. Industry expert Plinio Nastari's consulting firm Datagro estimates growth of approximately five percent in sugar cane milled for the 2009 season. Rabobank's models show a 2.4 billion liter increase in ethanol consumption (12 percent) even with a 50 percent reduction in car sales in Brazil. (Note: Brazil's ethanol consumption in 2008 was 19.6 billion liters of ethanol. End Note.) Furthermore, all industry contacts with whom Econoff met judged that Petrobras was unlikely to cut Brazilian gasoline prices. Despite a decline in world oil prices (after a peak in July 2008), Petrobras has maintained gasoline prices fixed in Brazil since 2005. As of February 10, the price of Brazilian gasoline is being sold at a 32 percent premium over the market price for gasoline with oil at USD 40 per barrel. As a result, consumers still prefer ethanol over gasoline. (Note: The generally understood price point for choosing

ethanol over gasoline is when ethanol is less than 70 percent of the price of gasoline. Ethanol in Sao Paulo, where 37 percent of Brazil's cars circulate, sold for 55 percent of the price of gasoline in January. End Note.)

¶12. (SBU) Rabobank estimated that ethanol exports, especially to the United States, would decline in 2009 by about one billion liters from 2008 (Ref B). Unlike Brazil, lower gasoline prices in the U.S. reduce incentives for distributors to increase the ethanol blend in gasoline. However, industry contacts expressed a more positive outlook for the external market over the longer term. Dedini's Oliveiro told Econoff that the U.S. market remains a positive future growth opportunity for many ethanol producers, but infrastructure projects to facilitate exports would be delayed due to the global financial crisis, limiting that market until financing returned to the sector. Private sector plans to build an ethanol pipeline and port terminals for ethanol exports have been put on hold. Giachini told Econoff he did not expect large scale new investments from the private sector until capital markets returned to normal functioning.

¶13. (SBU) Financing will continue to be scarce for the sector over the next few years until ethanol producers can show healthy balance sheets. Rabobank expects company balance sheets will be bad in ¶2009. Giachini explained that cashflow would recover in 2009 due to a better pricing for sugar and ethanol, but that debt and interest payments would increase with the currency depreciation. He indicated this fact would continue to plague financing. Because the fiscal year for many mills ends in March, Giachini suspected that weak balance sheets would limit financing until 2011, when the sector would recover.

Comment

¶14. (SBU) The effects of the financial crisis on the sugar and ethanol sector are real, though opinions are mixed as to the extent of the impact. There seems to be general agreement that Brazil's domestic ethanol demand is assured, and should continue to absorb all additional ethanol production even with falling oil prices. Domestic ethanol demand combined with the stable global demand for sugar, will likely pull the sector along despite the lack of financing. However, the lack of financing is likely to cause some plants to fold. In the short term, the growth of ethanol exports will likely be constrained, due to internal consumption of most of the available ethanol supply, as well as infrastructure challenges inhibiting large scale exports of ethanol, the solutions to which may be delayed by lack of available financing. In the long term, producers will look to overseas markets to complement the

anticipated increase in domestic demand. While the sector overall appears to be positioned to fare the crisis without too much damage, it is clear growth will probably slow in the near term. Despite somewhat reduced growth expectations for domestic industry, the GOB is likely to continue its drive to build a global ethanol industry, both as a tool for development aid and to increase the potential international ethanol market with an eye towards creating future buyers of Brazilian ethanol. However, the ability of third countries to find financing for these projects in the wake of the global financial crisis and the precipitous decline in oil prices remains to be seen. End Comment.

¶15. (U) This cable was coordinated/cleared by Embassy Brasilia and the Agricultural Trade Office in Sao Paulo.

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